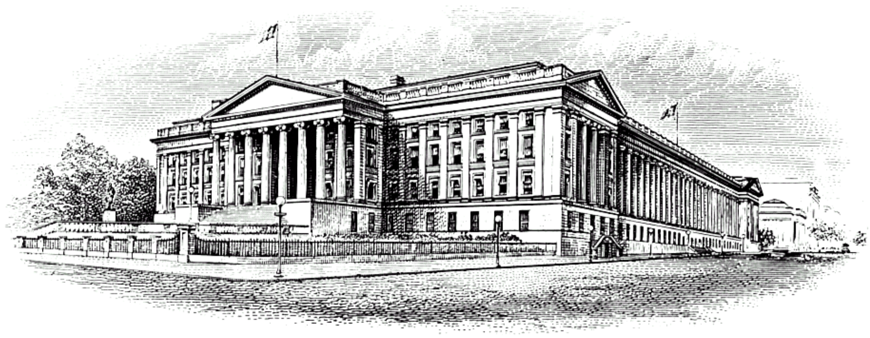

DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

EMBARGOED FOR RELEASE:
June 11, 2003
10:00 AM

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Treasury Under Secretary John B. Taylor
Testimony before the House Subcommittee on Domestic and International Monetary Policy, Trade and Technology of the House Financial Services Committee

Chairman King, Representative Maloney, Members of the Committee, thank you for the opportunity to testify today on the Millennium Challenge Account (MCA). My statement will focus on the economic rationale behind the MCA and how it fits within the Administration's overall approach to economic development.

Today there are more than three billion people living in extreme poverty. Last year 3 million people died for lack of immunization, 1 million died from malaria, 3 million died from water-related diseases, and 2 million died from exposure to stove smoke inside their own homes. In addition, HIV/AIDS has ravaged the populations of developing nations, killing 3 million people in 2002 alone.

The United States is helping in many ways to combat poverty and deal with these related problems. Under President Bush's leadership the Administration has developed a new economic growth agenda aimed at reducing poverty around the world. The MCA is one part of this agenda. The agenda focuses on channeling more funds to countries that follow pro-growth policies, and on structuring our contributions to create incentives for specific measurable results. These principles are the driving force behind Treasury's reform strategy at the Multilateral Development Banks (MDBs) as this committee is well aware. And I want to underscore the importance that the Administration attaches to the authorization requests related to the MDBs that are pending with this Committee. I look forward to working with this Committee and the Congress, to help make the MDBs strong and effective institutions. These same principles are the driving force behind the MCA. The MCA operates on the principle that aid is more likely to promote economic growth and raise living standards in countries that are pursuing sound political, economic and social policies. It also seeks to integrate measurement and evaluation into the design of activities to ensure that aid is working.

In a similar vein, I want to emphasize how transparent the Millennium Challenge Corporation (MCC) intends to be. The selection of countries will be based on an objective and transparent assessment of their policy performance on 16 indicators that are key to increasing economic growth. All contracts, activity implementation plans, and measurement and evaluation reports will be posted on the web. The United States is the leading force for increased transparency in the MDBs, and working in collaboration with this committee, we think we have come up with a robust agenda for even greater transparency that we will continue to pursue vigorously.

Treasury will play a vital role in the implementation of the MCA. The Secretary of the Treasury brings to the Board of MCC expertise in policies that promote economic growth and enhance productivity. Furthermore, as the U.S. Governor in the international financial institutions, the Secretary of the Treasury is in a unique position to ensure coordination of MCA programs with the World Bank, the regional development banks and other international financial institutions.

Removing Impediments to Productivity Growth

Sustainable poverty reduction can only be achieved via productivity growth. Productivity is the amount of goods and services that a worker produces per unit of time with the skills and tools available. If you want to reduce the number of countries with low per capita incomes, then you have no choice but to increase productivity in those countries. And the higher the rate of productivity growth, the faster poverty will decline. Simply put, the ticket out of poverty is higher productivity jobs.

Productivity depends on two things: capital per worker and the level of technology. If there are no impediments to the flow and accumulation of capital and technology, then countries that are behind in productivity should have a higher productivity growth rate. They should catch up, and we have seen many countries catching up over the years – such as South Korea, Chile, and Botswana. However, many of the poorest nations still have had low and stagnant productivity and income, and they are not catching up. More and more evidence has been accumulating that this is due to significant impediments to investment and the adoption of technology.

These impediments can be grouped into three areas. First, poor governance — the lack of rule of law or enforceable contracts and the prevalence of corruption — creates disincentives to invest, start up new firms, and expand existing firms with high-productivity jobs. This has a negative impact on capital formation and entrepreneurial activity. Second, weak health and education systems impede the development of human capital. Workers without adequate education do not have the skills to take on high-productivity jobs or to increase the productivity of the jobs they do have. Third, too many restrictions on economic transactions prevent people from trading goods and services or adopting new technologies. Poor economic policies, state monopolies, excessive regulation, and the lack of openness to trade are all examples of restrictions that reduce the incentives for innovation and investment that are needed to boost productivity.

The Administration's approach to assisting developing nations to increase their productivity growth is to increase aid to countries that are taking actions to remove these impediments by following pro-growth policies.

Measuring Pro-Growth Policies

President Bush speaks of three types of pro-growth policies: governing justly, investing in people, and encouraging economic freedom. Note that these three categories correspond to the three types of impediments holding back productivity growth.

To implement President Bush's vision, the Administration chose a set of quantitative indicators of these pro-growth policies. We worked intensively for several months evaluating a wide range of possible indicators. As part of this process, we met with representatives from other donor countries, developing countries, charitable organizations, universities, think tanks, the private sector, and other interested parties to gather their ideas.

Ultimately, we selected 16 indicators based on their relationship to economic growth, the number of countries they cover, their transparency and availability, and their relative soundness and objectivity. These indicators are not set in stone and may change in the future if problems with them emerge or better indicators become available. To qualify, a country will have to be above the median on half of the indicators in each of the three policy areas.

Governing Justly: There are six indicators in this category. The first two are from Freedom House and the latter four are from the World Bank Institute.

1) Civil Liberties: An indicator based on a survey of freedom of expression, association and organizational rights, rule of law and human rights, and personal autonomy and economic rights.

2) Political Rights: An indicator based on a survey of free and fair elections of officials; elected representatives have real power; the right of citizens to form political parties; freedom from domination by the military, foreign powers, totalitarian parties, religious hierarchies and economic oligarchies; and the political rights of minority groups.

3) Voice and Accountability: An aggregate index of existing quantitative indices of governance. One of these indices, for example, measures protection of civil liberties, citizen participation in the selection of governments, and the independence of the media.

4) Government Effectiveness: An aggregate index of such items as the provision of quality public services, competent and independent civil servants, and credible governments.

5) Rule of Law: An aggregate index of the extent to which people have confidence in and abide by rules of society, the incidence of violent and non-violent crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts.

6) Control of Corruption: An aggregate index that measures corruption among public officials including, for example, bribery, patronage, nepotism, and secret party funding. With respect to

this indicator, President Bush made it clear that MCA funds should only go to the most transparent and least corrupt countries. To meet the President's concerns, we have determined that those countries which fall below the median on this indicator will be considered ineligible for MCA funds, absent material change in their circumstances.

Investing in People: Our proposal includes two input measures and two output measures.

1) Public expenditure on health as a percent of GDP.

2) Immunization rate for DPT and measles: The World Health Organization publicly compiles and annually releases data on immunization rates for nearly all member countries.

3) Total public expenditure on primary education as a percent of GDP.

4) Primary Completion Rate: The World Bank, using UNESCO data, compile data that measure whether children are attaining minimum education levels. A higher level of education increases labor productivity.

Encouraging Economic Freedom: There are six indicators in this category covering both macroeconomic and microeconomic policies.

1) Country Credit Rating: Institutional Investor magazine produces a semi-annual survey of bankers' and fund managers' perceptions of a country's risk. A good credit rating reflects good overall economic policy conducive to growth.

2) Inflation: The rate of increase in prices over 1 year. Of the 16 indicators, this is the only one where performance is not judged relative to the median. Instead, a country must have inflation of less than 20% in order to pass the indicator.

3) Budget Deficit/GDP: A country's overall budget deficit is averaged over a three-year period.

4) Days to start a business: Compiled by the Private Sector Advisory Service of the World Bank Group, which works with local lawyers and other professionals.

5) Trade Policy: The Heritage Foundation's Index of Economic Freedom measures a country's openness to international trade based on average tariff rates and non-tariff barriers to trade.

6) Regulatory Quality Rating: The World Bank Institute measures the burden on business arising from, among others, licensing requirements, labor regulations, and bureaucratic corruption.

I should emphasize that none of these indicators is without some problem. There may be gaps or lags in the data, or trends not reflected in the data, which may be material for assessing performance. The MCC Board of Directors will have ultimate responsibility to exercise judgment and look behind the numbers to make a final recommendation to the President on qualifying countries.

Eligible Countries

The MCA aims to reduce poverty and is aimed at poor countries. In FY'04, countries eligible to borrow from the International Development Association (IDA), and which have per capita incomes below $1,435 (the historical IDA cutoff), will be considered. This is currently 74 countries.

In FY'05, all countries with incomes below $1,435 will be considered, which adds another 13 countries. In FY'06, all countries with incomes between $1,435 and $2,975 will be eligible to compete as a separate pool. This group currently consists of 29 countries. It is important to note that countries prohibited from receiving assistance by current statutory restrictions will not be eligible.

Measuring Results

The success of any foreign aid program requires that we measure results. This is a core component of the Administration's development strategy and is one that we have pushed in the Multilateral Development Banks (MDBs). For example, the United States made part of its financial commitment to the IDA-13 replenishment in the form of an incentive contribution that calls for making progress towards a set of development indicators in health, education, and private sector development. The agreement also called for the initiation of a performance measurement system which will develop ultimately into a common set of outcome indicators that can be compared across countries.

The MCA furthers this focus on measuring results by making sure that every MCA contract states in quantitative terms the expected outcomes. We will require a clear strategy for gathering baseline data and measuring progress toward stated results and assessing the reasons for success and failure. We will require projects to be structured in a way that steps up or cuts back funding contingent on achieving results. Evaluation of results will allow the MCA to incorporate lessons learned into ongoing and future operations. All measurement and evaluation reports, as well as the terms of each contract, will be made public in the United States and in the host country.

In addition to coordinating with USAID, coordination of assistance with other donors will be vital to the success of the MCA. Each recipient country will be responsible for managing coordination among the MCA and other donors to maximize impact and avoid duplication of efforts.

Conclusion

In summary, the MCA is an operational action plan to use taxpayer resources to help increase economic growth and reduce poverty around the world. I urge your favorable consideration of the "Millennium Challenge Act of 2003."